

# *Qard Hasan:* Its Sharī'ah Rules and Applications in Islamic Finance

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## Abstract

This paper provides a detailed explanation about the contract of *qard* (loan) as approved by Sharī'ah and analyses how it is applied in the contemporary Islamic finance industry. With regard to research method, it examines various Islamic banking and finance products structured on the principle of *qard* contracts and discusses the possible risks of non-Sharī'ah compliance in their structuring, and how they can be addressed and resolved. The main finding is that the issue of profiting from *qard hasan* contracts is very sensitive and many institutions are possibly compromising on Sharī'ah compliance through use of service charges and customary *hibah*-giving, etc. It is significant and attracts the attention of Islamic financial institutions to re-visit their products structured on *qard hasan* contracts. In general, it outlines the features of *qard hasan* contract and its application for benefit of the practitioners of Islamic banking all over the world.

**Keywords:** *Qard hasan*, *Hibah*, Service Charge, Islamic Finance, Sharī'ah Compliance.

## 1. Introduction

The Arabic word '*qard*' literally means to cut off or to tear something apart. However, *qard* in practice refers to the act of lending and giving loans, since the property of the lender is in essence cut off from the ownership of lender when it is loaned to the borrower (Kettell, 2011). Therefore, according to Muslim jurists, *qard* legally implies giving of anything with value in the ownership of another so that the receiver may avail the benefit of the lent item with the condition that the same item or its equivalent should be returned to the lender on demand or at a specified future date (Ibn Hazm, 1988). Hence, the *qard* (loan) approved by

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Sharī‘ah is one that is without a promise of benefits and gifts for the lender. Muslim jurists of the past have unanimously stated that loans which have compensations stipulated in contracts that will lead to repayment in excess of principal amounts or additional gifts/benefits for the lender are prohibited in Sharī‘ah as this leads to *riba* (Nawawi, 2009). In pre-Islamic times, borrowings amongst traders, merchants, consumers, buyers, etc. were highly usurious without proper written agreements and procedures and this led to grave injustice in the society (Hassan, 2007). Islam endeavoured to eradicate such injustice through the prohibition of *riba* (interest or *usury*) and thus, a valid *qard* contract in Sharī‘ah is in fact known as *qard hasan* that seeks no benefit.

The Arabic word *hasan* can be translated as splendid or beautiful. Thus, *qard* and *hasan* together refer to the act of extending a ‘beautiful loan’. As a proper definition, *qard hasan* can be defined as “an interest-free loan given for either welfare purposes or for fulfilling short-term funding requirements. The borrower is only obligated to pay back the principal amount of the loan.” (IIBI; 2007, P.19)

## 2. Legality of *Qard* Contracts in Sharī‘ah

The permissibility of *qard* (loan) contracts has been established from the Qur’ān and Sunnah as well as the *ijmā’* (consensus) of the Muslim scholars. Allah (swt) says in the Qur’ān, “*O you who believe! When you contract a debt for a fixed period, write it down.*” (2: *Al-Baqar’ah*: 188) According to the great classical scholar Abu Ja’far al-Tabari, this verse of the Qur’ān although directly specifies *al-dayn* (debt), but also refers to *al-qard* and *al-salam* (forward sale) contracts.

From the *Sunnah* of the Prophet (pbuh), it is narrated in Imam Ahmad ibn Hanbal’s *Musnad* that Allah’s Messenger is reported to have said, “*Allah will place a servant of Him under His shade on the day when there will be no shade except His shade, who waits (patiently) (any debt) from a borrower who lives in straitened circumstances or relinquishes for the debtor*”. This ḥadīth is interpreted in ḥassan (2007, p. 174) to refer to a lender who patiently waits for a poor or impoverished borrower to clear his debt and/or ultimately pardons the debtor and waives his right on the claim over the debtor. Therefore, this ḥadīth is also taken in context of permissibility of loan contracts. And finally, Al-Shaukani (2003) reports that there is an *ijmā’* of the Muslim scholars on the validity of *qard* contracts in Sharī‘ah. In fact, Al-Shaukhani further emphasizes that a *qard* contract is praiseworthy for the creditor and permissible for the debtor (Vol. 5, p. 229).

### 3. Merits of *Qard Ḥasan*

The word *qard ḥasan* directly appears a number of times in the Qur'ān. For example, Allah (swt) says in the Holy Qur'ān: “*Who is he that will lend to Allah qard ḥasan so that He may multiply it to him many times?*” (2: *Al-Baqar'ah*: 245). Further, in Surah At-Taghābun, “*If you lend to Allah a qard ḥasan He will double it for you, and will forgive you. And Allah is Most Ready to appreciate and to reward, Most Forbearing*” (64: *At-Taghābun*: 17). In Surah Al-Ḥadid, “*Who is he that will lend to Allah a qard ḥasan, then (Allah) will increase it manifold to his credit (in repaying), and he will have (besides) a good reward (i.e. Paradise).*” (57: *Al-Hadid*: 17).

From the above verses, many writers have interpreted that Allah (swt) regards extending of *qard ḥasan* as a loan to Allah Himself. For example, Mirakhor and Iqbal (2007) say that loan contracts in Sharī'ah are so called (*qard ḥasan*) “perhaps because, as the Qur'ān asserts, these loans are made to Allah (swt) rather than to the borrower and this eases the pain of ‘tearing away’ part of one’s wealth and lending it to someone in need” (p.19). However, these interpretations are not entirely accurate.

When the *fatwa* Committee chaired by Sheikh ‘Abd al-Wahāb al-Turayrī<sup>2</sup> was asked the meaning of lending to Allah a beautiful loan and whether it refers specifically to giving people interest-free loans, the *fatwa* issued stated, “In all of these cases, the term “beautiful loan” refers to spending in Allah’s cause specifically or spending in charity generally. It is not referring specifically to giving other people interest-free loans.”

This can be further reaffirmed from the *tafsir* of Ibn Kathir. Ibn Kathīr in his commentary on the Qur'ān, explains the meaning of a “beautiful loan” when he discusses Surah At-Taghābun, verse 17. He writes: “Whatever you spend, then Allah will replace it, and on Him will be the reward of whatever you give away in charity. Allah considered giving charity as if it is a loan to Him.”

About Surah Al-Hadid, verse 11, Ibn Kathīr says: “‘Umar bin Al-Khattāb said that this verse refers to spending in Allah's cause. It is also said that it pertains to spending on children. What is correct is that it is

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<sup>2</sup> For the full *fatwa* on *qard ḥasan* as in the verses of the Qur'an, please go to: <http://en.islamtoday.net/node/1345>.

more general than that. So all those who spend in the cause of Allah with good intentions and a sincere heart, fall under the generality of this verse.”

However, the hadiths of the Prophet (pbuh) directly emphasize the virtues of *qarḍ ḥasan*. In a hadith narrated in Ibn Majāh, it is reported by Anas ibn Mālik that Allah’s Messenger said,

*“in the night of the journey (m‘erāj), I saw on the gate of heaven written, ‘reward for sadaqah is ten times and reward for qarḍ ḥasan is eighteen times’. So I asked Jibrail, how is it possible? The angel replied, ‘Because beggar who asked had already had something but a loanee did not ask for loan unless he was in need’.”*

In another hadith narrated by Muslim, Abu Hurayrah (ra) reported that Allah’s Messenger said, “whoever relieves a believer from a difficulty in this world, Allah will relieve him from his difficulty and will facilitate him in this world and world hereafter.” Providing *qarḍ ḥasan* to those who are in need falls under the heading of relieving a believer from a difficulty in this world. Therefore, there is no doubt that providing *qarḍ ḥasan* with sincere intentions is a very noble act of worship in Islam.

#### **4. Conditions of *Qarḍ* Contracts**

Unlike conventional loans that are usually extended with a profit incentive, *qarḍ* contracts are categorized as charitable contracts (*‘uqud tabarru’*) or non-commutative contracts (*‘uqud ghair mu‘āwadah*) in Sharī‘ah and have to observe some conditions that are peculiar to it. The major conditions of *qarḍ* contracts are discussed in this section. In *qarḍ* contracts, the borrower is given full privilege and ownership over the lent item and he is free to utilize the item as he wills. However, he also assumes full responsibility and is obliged to return the loaned item in full. It is narrated in Ahmad, Tirmidhi and Ibn Majāh: *‘Abu Hurairah reported that the Messenger of Allah said: The soul of the believer remains hanging with his debt till it is paid.’*

Therefore, loans have to be repaid and there is guarantee of capital for the lender as the borrower assumes full risk of the loaned items. Due to this condition, any returns generated from the use of loaned items are *ḥalāl* and legitimate for the borrower based on the principles of *al-kharāj bi-ḥamān* (profits devolve with liability). The evidence for this can be found in the practice of the companion of the Prophet (pbuh), Zubayr bin Awam (ra).

Al-Zubayr ibn al-Awwam was one of the ten companions of the Prophet (pbuh) who were promised paradise in this worldly life. People always wanted to deposit their money with him for safekeeping (*wadi'ah*) due to his honesty. However, the contract of *wadi'ah* in Sharī'ah entailed that the money deposited for safekeeping cannot be used by Zubayr for his own means nor was he liable to provide guarantee for the deposited money unless he was proven negligent in his safekeeping. As a result, Zubayr asked people to provide him their money as a *qard* instead, so that he may be able to utilize the funds for his own purpose and consequently was fully responsible to repay the loaned money in all circumstances.

The most sensitive condition in *qard* contracts is that the lender is not entitled to demand any kind of benefit(s) from the borrower as a result of a loan. This is because there is no real risk for the lender as the borrower must have to repay under all conditions and specifying benefits in this transaction would lead to *riba*. Sawari et al. (2011) report that there is an *ijmā'* amongst the classical Muslim scholars that, "if the debtor promised to the creditor that gifts or benefits will be given to the creditor because of this loan, it would be prohibited as it would involve *riba* (p. 264)."

Amongst the contemporary scholars, Dr. Yusuf Qardawi (1998) states that in every loan, "*Riba* is a gift or benefit which was imposed as condition earlier" (p. 46). In a publication of Al-Azhar University, it is quoted from Ibn Al-Mundhir that, "They (scholars) have unanimously agreed that if the creditor imposed a condition upon the debtor of any increment or gift and he gave a loan on this commitment, truly, the taking of such excess (increment) would be *riba* (2003, p. 19)." And finally, the Sharī'ah Advisory Council of Bank Negara Malaysia states that, "*Hibah* (gift or present) cannot be imposed as a condition or promise in *qard* and *wadi'ah* contracts because it may lead to the element of *riba* (2008, p. 11)".

Therefore, the issue of *riba* is very sensitive in *qard* as it is one of the gravest major sins in Islam. It is narrated in Musnad Ahmad that: '*the Messenger of Allah said: A dirham of usury a man devours with knowledge is greater than thirty six fornications.*'

It is useful to mention here that Sharī'ah permits *Husnal qada* or gracious repayment of loans/debts. *Husnal qada* is when a borrower repays the lender in excess of the principal out of free consent and without any precondition or demand by the lender. This is compatible with the *Sunnah* of the Prophet (pbuh) where in a hadith reported in sahih Muslim,

Jabir (ra) narrated that the Prophet (pbuh) owed him a debt and he repaid Jabir in excess of the principal (Cf: Najeeb, 2012, p. 44).

Amongst other conditions of *qard* contracts are that the two parties engaging in *qard* should have the appropriate legal capacities (*āhliyyat*); a clear offer (*ijāb*) and acceptance (*qabul*) made before entering into the contract; it is strongly recommended (obligatory according to minority opinion) to write down the loan contract; recommended to take two witnesses; and the subject matter of the contract (the item to be given as loan) must also be present.<sup>3</sup>

**Box - 1: Summary of Major Conditions of *Qard* Contracts**

1. Non-commutative contract which provides divine rewards as opposed to material rewards.
2. Borrower assumes full ownership of the item and is free to utilize it as he wills.
3. Borrower assumes full risk of the item and obliged to repay lender under all circumstances.
4. Any returns generated from the use of loaned items are legitimate for the borrower.
5. The lender is not entitled to any kind of predetermined benefit(s) from the borrower as a result of this loan.
6. However, a borrower may repay the lender in excess of the principal out of free consent and without any precondition or demand by the lender.
7. The elements of contracts such as offer (*ijāb*) and acceptance (*qabul*), contracting parties and their legal capacities, subject matter, etc must be met.
8. It is strongly recommended (obligatory according to minority opinion) to write down the loan contract.
9. It is recommended to take two witnesses.

<sup>3</sup> For more details on conditions for *qard* contracts, see Hossain (2011) “*qard hasan: A Practical Approach*”

## 5. *Qard* Contracts in Islamic Finance

The contemporary Islamic finance industry makes use of *qard* contracts in a number of their products and services. However extreme care has to be taken in structuring such products as there is always the danger of falling into *riba* transactions as elaborated in the previous section. This section will review these products and services and highlight various issues surrounding their structuring particularly from the perspectives of risks of Shari'ah non-compliance.

### 5.1 Deposit Products Based on *Qard*

The Islamic financial institutions like their conventional counterparts also offer current and savings accounts to their clients for depositing money. The Shari'ah compliant contracts utilized in structuring these accounts are either *qard / wadi'ah bid ʿā amān* or *mudārabah* (AIBIM, 2008).

For current/savings accounts structured under the concept of *qard*, the client provides an interest-free loan to the bank through deposits and the bank may utilize the funds for its own means. (It may be noted that in many jurisdictions, Savings Deposits are taken on the basis of *mudārabah*.) The client at any time may withdraw his funds and the bank is obliged to return the amount in full. The bank at its sole discretion may reward its depositors through means of *hibah* (gift) that have not been predetermined or promised earlier in the *qard* contract (Bakar, 2008a, p.71). However, many Islamic banks, particularly in Malaysia and Iran, usually offer deposit products under the structure of *wadi'ah bid ʿā amān* which is translated as safekeeping with guarantee. According to Al-Zuhayli (2006), a *wadi'ah* contract will change into a guarantee contract (*wadi'ah bid ʿā amān*) if the trustee violates the principles of a *wadi'ah* contract for example by using the deposited item for his own use; for merging the deposited item with that of others, etc<sup>4</sup>. Islamic banks take their clients' deposits and use them for their own means as well as merge one client's money with the others'. This practice implies that the contract is of *wadi'ah bid ʿā amān*. But in fact, Muslim jurists have likened the Islamic banking products structured under *wadi'ah biddamān* concept to *qard* contracts and stated that all conditions pertaining to *qard* contracts are applicable on it. Dr Qardawi (1998) stated that in a *wadi'ah bid*

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<sup>4</sup> For a full list of cases where a *wadi'ah* (safekeeping) contract changes into a *wadi'ah yad damānah* contract, please see Al-Zuhayli (2006), Pp. 4024-4033.



٢ *amān* product, the bank's relationship with the client should be that of a debtor with creditor. The Islamic Fiqh Academy of OIC (1998) also concluded that, "*Savings money in an account that may be withdrawn at any time, whether in Islamic banks or conventional banks, are considered as loans in the view of Fiqh ruling. The bank, as a receiver of the deposit, is responsible for the deposit and must return when demanded by the depositor. The bank keeps the savings with a guarantee responsibility.*"

Therefore, deposit products under the principles of *wadi'ah bid damān* are also *qard* contracts from the *fiqh* point of view and so all rules of *qard* contracts are applicable on them. In essence, there can be no promise of additional rewards to the depositors and if there are any rewards in future, it must be in the form of *hibah* (gift) at the sole discretion of the bank.

## 5.2 Charge Cards/Credit Cards based on *Qard*

Islamic financial institutions are also able to offer charge cards and credit cards to their clients structured on the principles of *qard hasan*. From the conventional perspective, the difference between a charge and credit card is that there are no revolving credit facilities in a charge card whereas the facility exists in a credit card (Bakar, 2008b, p. 117). From Islamic perspective, the revolving of credit with higher repayments against time is *riba* and therefore, charge cards and credit cards based on underlying contracts of *qard hasan* are similar in nature and will be discussed together<sup>5</sup>. This structure of credit card is referred to as the '*ujrah* (fee based) Islamic credit card.

In an '*ujrah*-based Islamic credit card, the customer may use the card at any supported merchants/outlets / point-of-sale (POS) terminal to make payments or to withdraw cash from any ATM. At the time of payment/withdrawal, the issuing IFI is said to have extended a *qard hasan* to the customer. The customer is then to repay this loaned amount without interest before a specified time period. The catch here is that the bank charges a fee ('*ujrah*) from the customer for providing this credit card service (Engku Ali, 2008, p. 155).

The issue regarding charging this fee is very sensitive since the money being extended to the customer is on the basis of *qard hasan* and there is

<sup>5</sup> As an example of an Islamic charge card, see HSBC *amānah*'s Charge Card or Al-Rajhi's charge card. '*ujrah* - based Islamic credit cards were common in banks in United Arab Emirates. However, nowadays most banks offer *tawarruq* or *ijārah* - based Islamic credit cards that allow them to earn profits.



an imminent risk of *riba* creeping in. Skeptics have questioned what is this service fee for? The Islamic Fiqh Academy of OIC (1986) has ruled that this service fee must be fixed in terms of an absolute amount based on actual cost incurred by the issuing IFI in providing this facility. The service fee should not vary according to the amount withdrawn. Other than the actual cost, if the IFI charges additional amount from the customer, it leads to *riba*. This issue of service fee is further discussed in later sections of the paper.

### 5.3 Financing Products Based on *Qard*

Unfortunately, the role of extending financing through *qard* has been very limited in the Islamic financial industry and this is mainly due non-permissibility of taking profit in such products (with the exception of Iran where most banks are state-owned and, according to their opinion, payments of excess on loans by different organs of the government is not considered as *riba* (Ayub, 1994). In a survey conducted by Ariffin and Adnan (2010) asking Malaysian Islamic bankers on problems in offering *qard* financing, the results indicated six main reasons in the following order of prevalence: “Not able to generate any profit; not able to cover the financing; high administrative and transaction costs; high risk; no support from top management; and no demand from customers” (p.21). To emphasize their point, Ariffin and Adnan (2010, p. 14) provide statistics which indicate that only 3 banks in Malaysia reported *qard hasan* in their financial statements. These were Bank Muamalat (RM5.65 million outstanding *qard hasan*), Al-Rajhi (RM2.84 million) and KFH Malaysia (RM33,000). As part of the total outstanding financing, these are only 0.1%, 0.15% and 0.001% respectively for each of the three banks.

According to Khan (2008), Islamic banks usually provide *qard hasan* to their existing clients or restrict this facility only for the very weak and needy sections of the society. However, the concept is widely used in providing microfinance by NGOs, charities, religious organizations, etc. Islamic micro financing based on *qard hasan* contracts will be explored in the next sub-section. As an example of *qard hasan* financing, Dubai Islamic Bank in UAE offers *qard hasan* to its existing customers in order to help them overcome financial difficulties. The *qard* is mainly directed at facilitating social needs such as marriage, education and situations beyond the control of the applicant like prolonged delay in salaries or wages (Atan, 2009, p. 8). The *qard hasan* fund consists of funds from the bank itself but also includes contributions from other individuals, financial corporations, business organizations and even the government. The

recipients are granted one year's time for repayment with installments starting within a month from the date of receiving the *qard*.

However, financing based on *qard hasan* by Islamic banks is popular in the Islamic Republic of Iran where the banks (mostly state-owned) collaborate with local mosques, religious organizations, and at times with professional associations to extend small consumer and producer loans on the basis of *qard hasan* (Mirakhor and Iqbal, 2007). The *qard hasan* fund is made up of contributions by the well-off and capable individuals of the society who have guarantee on their capital by the banks and they are free to withdraw their funds any time they desire. There is no interest charges involved, but some banks do charge administrative costs from the recipients of *qard hasan*. One controversial issue surrounding financing products based on *qard hasan* is the charging of the administrative costs.

According to Shari'ah Standards of AAOIFI, charging of service cost is allowable, provided that it is the actual cost (Atan, 2009, p.10). Farooq (2010) explains that charging service fees on *qard hasan* is allowed provided it is to cover the actual administrative costs incurred in processing and extending the *qard* to the client. However, these should not be related to the amount or time period of the *qard*. It should be fixed and representative of the actual costs. But what is found in practice is that service fees on *qard hasan* are in fact charged as a percentage ranging from 1% to 3% of the loaned amount (Khan, 2008, p.15). The percentage in some jurisdictions is issued by the governing regulator while in other cases a formula is used to arrive at the figure by the financial institution themselves. For example, Ahmad (1993) reports that maximum service charges on loans in Pakistan are calculated using the following formula<sup>6</sup>:

Service charge:  $(E/A) \times 100$  where

*E*: administrative expenses during the year

*A*: average assets during the year

Is this percentage method of calculating service costs on *qard hasan* legitimate given the fact that based on the percentage method, the service charge directly varies with the amount being extended as *qard hasan*? Both AAOIFI standard and resolution of OIC IFA have clearly stated that service charge on *qard hasan*/Credit Cards should not be linked to the amount of financing being extended and must be a fixed value

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<sup>6</sup>This formula is not used by Islamic banks in Pakistan working in the framework announced in 2002. Further, currently there is no scheme of *qard hasan* financing by Islamic banking institutions (IBIs) in Pakistan.

representative of the actual cost. This issue is a matter of grave concern which Islamic banks must clearly rectify since if these service charges are not actual costs, then they are *riba*. And *riba* is the only sin in Islam on which the Qur'ān says, "...take a notice of war from Allah and His Messenger..." [Surah Al-Baqarah (2), Verse 279].

#### 5.4 Micro-Financing Products Based on *Qard*

The concept of micro financing in the conventional finance industry originated from the Nobel Prize winning initiative by Professor Muhammad Yunus with Grameen Bank in Bangladesh in 1976. Grameen Bank's official charter (2011) describes this initiative as "an action research project to examine the possibility of designing a credit delivery system to provide banking services targeted at the rural poor." Being a conventional finance project, this type of micro-financing indulges in *riba*.

On the other hand, Islamic micro-financing schemes based on principles of *qard ḥasan*, while being non-existent in most Islamic banks, are widely operated and implemented by the informal sector in the Muslim world consisting of NGOs, religious organizations, charitable trusts, etc. As per Khan (2008), these informal institutions have allowed small producers, farmers or entrepreneurs who are unable to receive finance from other commercial banks or other lending institutions to be able to receive much needed liquidity as *qard ḥasan*.

To give a few examples, the Akhuwat foundation in Pakistan extends *qard ḥasan* to various needy individuals of the society. The service charges are very low [only \$1.14 in 2011] per application and are fixed regardless of *qard* amount requested. The contributions to the *qard ḥasan* fund and expenses of the organization are managed through donations (*Akhuwat, n.d*).

The *Ansar Personal Loans* in UK also operates a micro financing scheme based on principles of *qard ḥasan*. It has a list of registered members who each pay GBP 10 a month as donation to the *qard ḥasan* fund. The donations are also used to pay for the expenses of running the organization. No service fees are charged on extending the *qard ḥasan* although only its registered members are entitled to avail the *qard ḥasan* facility (El Diwany, 2010). There are some Sharī'ah objections raised in this model since the facility to avail *qard* is conditional by donating to the organization, in addition to to registering; while contingent/conditional contracts are not permitted in Sharī'ah. However, Ansar argues that their donations and their *qard ḥasan* facility are independent to each other and unilateral in nature. Mirakhor and Abbas (2007) report a number of small

scale micro/rural banks in Indonesia providing micro-financing on the principles of *qardḥan*. Khan (2008) also reports *qardḥan* micro-financing by Islamic Relief organization in Kosovo, Bosnia & Herzegovina and Pakistan.

In a summary, *qardḥan* micro-financing is a crucial financial instrument for alleviating hardships and redistributing income amongst the needy segments of the society<sup>7</sup>. Grameen bank is accredited to transforming millions of lives in Bangladesh with its micro financing scheme while charging interest rates as high as 30% on outstanding amounts. What is the potential of transformation from *qardḥan* micro financing; an interest-free Sharī'ah endorsed loan? The Islamic financial industry should consider providing such services on a formal platform as a benevolent gesture to improve the state of affairs of the Muslim 'Ummah as well as to attract non-Muslims to Islam.

### 5.5 Government Securities / Private Debt Securities

In order to facilitate liquidity flow amongst Islamic financial institutions, the contract of *qardḥan* has also been used to create public and private debt securities that allow effective liquidity management for Islamic financial institutions. These securities are developed on the underlying contract of *qardḥan*, and the lender gives an interest-free loan to the borrowing institution. We will discuss a few examples of both government and private debt securities based on *qardḥan* from the Malaysian markets as the Malaysian Islamic interbank, capital and secondary markets are most advanced amongst the Islamic finance nations due to relatively more flexible juristic approach.

As an example of government securities, the Malaysian government, back in 1983, issued the Government Investment Certificates (GICs; now replaced with Government Investment Issues) on the basis of *qardḥan* in order to facilitate Islamic banks and Islamic windows to comply with central bank's statutory liquidity requirements as well as to park their idle funds (Bakar, 2008c, p.431). The conventional central bank instruments such as treasury bills are interest-bearing and, therefore, Islamic banks cannot hold such liquid papers (BNM, 2009). GICs could be bought and sold at par at the central bank depending on the liquidity needs of the institutions. However, such GICs were not tradable in secondary markets

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<sup>7</sup> To read about real world examples of how *qardḥan* micro financing has transformed lives of its recipients, please read Islamic Relief's (2008) report on Islamic Microfinance pgs 27-35

since it makes no economic sense to trade these certificates at any values other than par.

As a result, over time, the government securities in Malaysia have moved towards using other underlying contracts such as that of *bai' al-'inah*, *mudārabah*, and more recently commodity *murābaha* to enable trading of these securities in secondary markets and allow participants to make some profits<sup>8</sup> (Dusuki, 2008a, p. 178). According to BNM, "Since *qardḥasan* concept is essentially benevolent in nature, it is improper to implement it in commercial transaction with profit orientation."

Nonetheless, the Malaysian government has been experimenting with another Sharī'ah compliant instrument known as Malaysian Government Certificates (MGCs) that is based on *qardḥasan* and reflective of borrowing by the government from its citizens, financial institutions, etc. These certificates have varying maturities and are issued at par in multiples of RM 10,000 and can be redeemed on maturity or at demand at par value from Bank Negara Malaysia (Al-Amine, 2008, p. 525). Bank Negara, at its sole discretion, may also reward the certificate holders' monetary benefits in the form of dividends based on the principle of *hibah* (gift-giving).

In the case of Islamic private debt securities (IPDS), the use of *qardḥasan* is very limited since there are no economic benefits to be made. Therefore, issuance of private debt securities on principles of *qardḥasan* has mostly been between parent and subsidiary companies where profiting from lending is not the motive. For example, in 1994 Petronas Dagangan Berhad (PDB) issued RM 300 million worth of IPDS to its parent Petroleum Nasional Berhad (PNB) as an interest-free loan. However, these IPDS did have 120 million detachable warrants attached with them in the form of transferable subscription rights for the lender (Engku Ali, 2008b, p. 453). Therefore, these were later criticized for possible non-Sharī'ah compliance as these warrants represented extra benefit for the lender.

As a review for this sub-section, it should be recalled that the spirit of *qardḥasan* in Sharī'ah is *tabarru'* (charitable) and not for profit-making purposes. Based on this, Al-Amine (2008) cautions that product structures

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<sup>8</sup> The selling of securitized debts (Bay al-dayn) at values other than par is a controversial issue in Islamic Finance that is heavily debated. It is not in the scope of this paper to discuss the issue but readers may refer to Engku Ali (2008b) 'Issues in Islamic Debt Securitization' for in depth understanding.

using *qardḥasan* principles which form implicit expectations in lender's mind of *hibah* should be used carefully. According to Al-Amine, if this gift-giving in the form of *hibah* becomes the custom and general practice, then it may be considered extending loans with *riba*. The acid-test of lenders' intentions who subscribe to such products would be when the borrower does not provide any *hibah* and repays the exact principal back in maturity.

## 5.6 Takāful Products

The use of *qardḥasan* is also found in some models of *takāful* (Islamic insurance) as practised by the *takāful* operators in the industry. Describing *takāful* models is beyond the scope of this paper.<sup>9</sup> But in brief, *takāful* models are normally based on Sharī'ah concepts of *wakālah*, *muḥārabah* and/or *waqf*. Based on these concepts, *takāful* operators maintain different pools of money received from clients for various purposes, for e.g. savings a/c for long-term life Islamic insurance; risk account for more frequent motor or fire or accident *takāful* etc. *Qardḥasan* is used to transfer funds between these accounts whenever there is a shortfall in one. For example, if there is underwriting deficit - a shortage of funds in the risk account at a particular time while there are excess funds in the savings account, the required funds from the savings account may be transferred to the risk account as a *qardḥasan* or even as a donation. Therefore, it represents an internal funds transfer on the basis of *qardḥasan* or *tabarru'* and the motive is not to profit from this transfer but to alleviate liquidity issues.

## 6. Issues

It has been established in this paper so far that granting a *qardḥasan* is a noble and virtuous act of worship in Islam. The lender of *qardḥasan* having sincere intentions is promised of abundant rewards from Allah (swt) However, the contract of *qardḥasan* is governed by rules and regulations in Sharī'ah of which the most sensitive is the impermissibility of contracting benefits for the lender as a result of the *qardḥ* extended. Based on such rules, the contract of *qardḥasan* has failed to make inroads in the Islamic finance industry. Currently, the levels of financing by IFIs in the form of loans or debt securities on principles of *qardḥasan* are negligible. However, there are some activities by IFIs in offering charge cards/credit cards, micro-financing and other basic short-term

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<sup>9</sup> Interested readers can refer to pgs. 327-349 in El Diwany (2010) for an explanation on the various models of *takāful* operations as practiced in the industry.

small amount financing on the principles of *qardḥan* as we have reviewed in the paper. But, the contentious issue involved in such products is that the lending institutions charge a ‘service fee’ from the recipient. While AAOIFI, OIC and other scholars have expressed permissibility of this fee, they clearly stated that it must be the actual cost in processing the applications of *qardḥan* and any additional benefit for the lender is *riba*.

Yet, as observed earlier, in practice the lenders usually charge service fee as a percentage of the amount being extended (which leads to the service fee varying with the amount of *qardḥan*) or as a fixed amount based on some average estimate. Are these the real and actual costs of providing the service? According to one Sharī‘ah auditor in a local Malaysian Islamic bank<sup>10</sup>, banks are in fact able to profit from collecting such service fees if they are able to generate large volumes of transactions. The auditor gave example of an *‘ujrah*-based Islamic credit card. The service fee in his bank is fixed but based on an average cost estimate. If the bank exceeds the original budgeted number of clients and transactions for its credit card product which it used to estimate the average cost, it will be in profit as its service fee collections will exceed actual costs.

This is a very sensitive and delicate issue that cannot be taken lightly and efforts must be made to rectify the problem. As established from Qur’ān and Sunnah that profit on *qardḥan* is *riba* and if *riba* creeps in these *qardḥan* transactions, the lending institution and the client both are equal in sin. And we have established earlier how heinous a sin is *riba* in Islam!

For the case of deposit products and government securities where *wadi’ah yad damānah* / *qardḥan* contracts are used in mobilizing funds and which award non-stipulated monetary rewards as *hibah*, concern has been expressed by certain writers. If such rewards in the form of *hibah* become the norm and general practice, and the lender expects to receive and the borrower expects to give a certain percentage as *hibah*, then this may become a violation of *qardḥan* contract and abuse of the spirit of *husnal qadha* principle in Sharī‘ah. As mentioned earlier in the paper, the acid-test of lenders’ intentions in these cases would be when the borrower does not provide any *hibah* and repays the exact principal back in maturity.

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<sup>10</sup> The concerned individual requested full anonymity of his and his employer’s identity.



## 7. Recommendations

Islamic financial institutions must find alternative ways to cover their administrative costs involving *qardḥasan* contracts. Mirakhor and Iqbal (2007) suggest that lending institutions can cover their administrative costs by investing fractions of their *qardḥasan* funds in Sharī'ah compliant investment opportunities or instead by engaging in *muārabah/mushārah* contracts with their clients. It must also be kept in mind the spirit of *qardḥasan* in Sharī'ah is *tabarru'* (charitable) and not for profit-making purposes.

A major concern for banks in providing micro-financing is the risk inherent in financing activities involving the poor and small entrepreneurs. As a possible solution, Dusuki (2008b) proposes banks to engage in micro-financing activities through a bankruptcy-remote Special Purpose Vehicle (SPV) that would allow the core balance sheet of the financial institution to be protected from adversaries in the micro-financing activities. Therefore, within the context of Islamic finance and use of *qardḥasan* contracts, Dusuki's model proposes the following basic procedures for *qardḥasan* financing through SPV:

- (1) The Islamic bank mobilizes various sources of funds with specific microfinance objectives.
- (2) The Islamic bank creates a bankruptcy-remote SPV.
- (3) The bank allocates certain amount of funds and passes it to the SPV.
- (4) The funds are channelled to various clients depending on needs and demands. For example, *zakah* funds may only be allocated to poor clients for consumption purposes and capacity building initiatives, while other type of funds can be used to finance their productive economic activities.

Through this model using SPV, the Islamic financial institution can specialize in using non-commutative contracts such as *qardḥasan*, *awqaf* (endowments), *sadaqah* (donations) etc. to engage in micro-financing activities amongst the needy sections of the society. The administrative costs can be recovered through investing portions of the funds in Sharī'ah compliant investment opportunities or by instead engaging in *mudārabah/mushārah* contracts with their clients. With regards to the issue of gift-giving (*hibah*) on *qardḥasan* becoming customary, this could be overcome in financial institutions through randomly omitting paying *hibah* for some months of the year. Therefore, by adopting such measures, there is no certainty of regular monthly *hibah* payments.

## 8. Conclusion

In conclusion, it is regrettably noted that *qard ḥasan* is not widely extended by IFIs due to a absence of profit incentive. To this end, it must be questioned that are profits the only objective of a commercial company as per Islamic perspectives? Community welfare in the form of CSR is now increasingly being endorsed by conventional companies. *Qard ḥasan* can be a form of CSR for IFIs that not only gains public appreciation but also divine rewards for parties involved. Therefore, *qard ḥasan* contract needs to be further researched in order to preserve its original spirit in current practice and also to find ways to enhance its application in the industry. We noted earlier that if a *riba* -based Grameen bank can be commended for transforming millions of lives, we can only imagine the potential of the blessed contract of *qard ḥasan*!

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